



Issue Date July 5, 2005
Audit Report Number 2005-SE-1006

TO: Brian D. Montgomery, Assistant Secretary for Housing - Federal Housing
Commissioner, H

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region X, OAGA

SUBJECT: Washington Mutual Bank, Seattle, WA, Washington Mutual Bank Submitted
609 Late Endorsement Loans with Unacceptable Payment Histories

HIGHLIGHTS

What We Audited and Why

We audited late endorsement payment histories at Washington Mutual Bank (Washington Mutual), Seattle, Washington. We selected Washington Mutual because of its high number of late single-family loan submissions for Federal Housing Administration insurance during calendar years 2002 and 2003. Our objective was to determine whether Washington Mutual's late requests for endorsement complied with the U.S. Department of Housing and Urban Development's (HUD) payment history requirements.

What We Found

From March 2002 to October 2004, Washington Mutual improperly submitted 609 loans to HUD, totaling more than \$69 million, for insurance endorsement when the borrowers had delinquent payments within six months before the

submission date. This occurred because Washington Mutual did not have adequate controls to ensure that its employees followed HUD's requirements regarding late requests for insurance endorsement. However, in response to Federal Housing Administration Quality Assurance Division findings, Washington Mutual began planning and implementing improvements to its organization, procedures, and controls in July 2003 and achieved a reduction in late endorsement submissions during 2004.

What We Recommend

We recommend that HUD take appropriate administrative action up to and including recovery of losses on \$1,091,214 in paid claims and indemnification of loans with a total mortgage value of \$18,695,819. These loans were not current when submitted for endorsement (see appendix A). We also recommend that HUD take appropriate administrative action against Washington Mutual for violating the requirements in effect at the time when it submitted loans without proper six-month payment histories.

Auditee's Response

We provided Washington Mutual a draft report on May 12, 2005, and held an exit conference with Washington Mutual officials on May 26, 2005. Washington Mutual provided written comments on June 10, 2005. The written comments generally agreed with our report findings, but disagreed as to their significance. Washington Mutual disagreed with the extent of recommended indemnifications citing recent changes in HUD's late submission requirements and the materiality of the internal control weakness for late endorsements. Upon evaluating the written comments, we adjusted our recommendations to reflect HUD's recent change in the late submission requirements. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within the U.S. Department of Housing and Urban Development (HUD). The Federal Housing Administration provides insurance to private lenders against loss on mortgages financing homes. The basic home mortgage insurance program is authorized under title II, section 203(b), of the National Housing Act and governed by regulations in 24 *Code of Federal Regulations* 203.

Through the direct endorsement process, the lender underwrites and closes the mortgage loan without prior HUD review or approval. The purpose of late request for endorsement procedures is to ensure that the degree of risk to HUD is no greater than existed at the time of closing, before the mortgage may be endorsed. A request for insurance endorsement is considered late and triggers additional documentation whenever the binder is received by the appropriate HUD home ownership center more than 60 days after mortgage loan settlement or funds disbursement, whichever is later. The Federal Housing Administration believes that this is sufficient time for the mortgage lender to assemble the binder, obtain any final documents or signatures, and ship the binder to the appropriate center for endorsement.

Washington Mutual Bank (Washington Mutual) has an administrative office in Seattle, Washington and is a supervised direct endorsement lender approved to originate Federal Housing Administration-insured single-family loans. In a series of acquisitions beginning in 2001, Washington Mutual acquired two federal savings banks that had mortgage lending operations: Bank United and The Dime Savings Bank of New York, FSB, which owned North American Mortgage Company. Washington Mutual also acquired three other mortgage companies: PNC Mortgage Corporation of America, Fleet Mortgage Corporation, and HomeSide Lending, Incorporated. From 2000 to 2003, Washington Mutual's total home lending and refinancing for conventional and insured mortgages increased from \$51.5 billion to \$384.2 billion; it decreased to \$212.4 billion in 2004.

During the period from March 2002 to October 2004, Washington Mutual submitted 64,905 Federal Housing Administration loans worth \$7.4 billion with closing dates from January 2002 through June 2004 to HUD for insurance.

Our objective was to determine whether Washington Mutual's late requests for endorsement complied with HUD's payment history requirements. The audit steps were designed to detect endorsed loans for which the borrowers made late payments before the lender submitted the loan to HUD for insurance endorsement. Washington Mutual provided significant resources and valuable assistance in support of this audit.

RESULTS OF AUDIT

Finding 1: Washington Mutual Submitted 609 Late Endorsement Loans with Unacceptable Payment Histories

From March 2002 to October 2004, Washington Mutual improperly submitted 609 loans, totaling more than \$69 million, as late requests for insurance endorsement to HUD when the borrowers had mortgage payment delinquencies within six months before the submission date. This occurred because Washington Mutual did not have adequate controls to ensure its employees followed HUD's requirements regarding late requests for insurance endorsement. Consequently, the inappropriately submitted loans increased the risk to the Federal Housing Administration insurance fund.

HUD Requirements

For our audit period, HUD Handbook 4165.1, REV 1, required that loans submitted for insurance endorsement more than 60 days after closing meet certain late request standards. The standards included ensuring that the borrower has made, within the calendar month due, all loan payments up to the time of submission or at a minimum, made six consecutive monthly payments within the calendar month due. They also required that the current month's payment be received when submitting loans after the 15th of the month. These rules were further clarified by HUD Mortgagee Letter 2004-14.

Improperly Submitted Loans

After obtaining and reconciling the electronic records from HUD and Washington Mutual, we tested for the presence of unacceptable payment histories on loans submitted as late requests for insurance endorsement. Our automated analysis of the payment histories provided by Washington Mutual and endorsement data from HUD's systems showed that for the 37,648 loans with late endorsement requests tested, Washington Mutual submitted 1,011 loans with questionable payment histories.

Washington Mutual reviewed the 1,011 payment histories and provided reasonable explanations for 402 transactions. Washington Mutual agreed that the remaining 609 loans were submitted as late endorsement requests even though the borrowers had unacceptable payment histories before submission.

Late endorsement loans with unacceptable payment histories present a higher risk to the Federal Housing Administration insurance fund in comparison to other loans. Of the 609 loans submitted with unacceptable payment histories, 126 (20.69 percent) have defaulted since insurance endorsement, compared to approximately 4 percent for all Washington Mutual loans.

	Number of loans	Number of defaults as of March 2005	Default rate	Number of claims as of March 2005	Claims rate
All loans during audit period	2,825,498	201,473	7.13%	29,056	1.03%
Originated or sponsored by Washington Mutual from Jan. 1, 2002, through June 30, 2004	64,905	2770	4.27%	373	0.57%
Late endorsement loans tested	37,648	1494	3.97%	205	0.54%
Late endorsement loans with unacceptable payment histories	609	126	20.69%	17	2.79%

As of May 2005, 50 of the 609 loans have been paid in full and no longer represent a risk to the Federal Housing Administration insurance fund. Of the remaining 559 loans, 18 have proceeded to claims, and 541 are still insured and pose a risk to the Federal Housing Administration insurance fund.

HUD Changed its Late Loan Submission Requirements

On May 17, 2005, after the completion of our audit, HUD issued Mortgagee Letter 2005-23. This Mortgagee Letter changed HUD's requirements for loans submitted late for endorsement and only requires lenders to certify that the most recent payment that came due was made within the month that the loan was submitted. The Mortgagee Letter eliminates the requirement that loans submitted late are not eligible for endorsement until six consecutive payments have been made prior to and/or within the calendar month due. According to the Mortgagee Letter, "FHA believes its risk at insurance endorsement is based by the status of the mortgage at the time of endorsement and is, therefore, eliminating this requirement in the late endorsement request."

Of the 559 loans reported above, 179 were not current at the time they were submitted to HUD for insurance endorsement and would not have met the new requirements.

We provided HUD officials and Washington Mutual with spreadsheets identifying the loans improperly submitted to HUD as late requests for endorsement. We have not included the detailed spreadsheets in this report but can provide them upon request.

Controls Needed Improvement

Washington Mutual submitted loans with unacceptable payment histories because it did not have a control environment sufficient to ensure that its employees followed HUD's submission requirements for late endorsements and was not adequately prepared to handle a rapid increase in its single-family lending business.

A July 2003 Washington Mutual internal audit report acknowledged weaknesses and recommended improvements to controls over government lending and insurance. As a result, Washington Mutual began reorganizing and developing new controls over its mortgage lending activities. Washington Mutual currently operates two national post closing operations centers in Florence, South Carolina, and Jacksonville, Florida. Since the reorganizations, these centers perform servicing functions as well as certain post closing activities more commonly associated with originating, including obtaining Federal Housing Administration insurance endorsements.

Current controls contain new processes to track the status of loans from closing to insurance endorsement. Washington Mutual added to its operating instructions quality control steps that test Federal Housing Administration requirements within the process centers and also centrally by its servicing risk oversight organization. These steps include specific attention to the payment history issue; however, they do not address the requirement that the current month's payment be received when submitting after the 15th of the month. Washington Mutual agreed to incorporate this additional requirement into its operating instructions and quality control checklists used to check for six months of acceptable payment history.

Washington Mutual also acknowledged that it was not prepared to handle the sudden increase in mortgage volume that occurred in 2002. The increase in mortgage volume was due to decreasing interest rates, resulting in an increase in refinance activity. The problem was intensified by the growth of Washington Mutual's mortgage business from numerous acquisitions of other mortgage lenders.

During our audit timeframe of January 2002 to June 2004, Washington Mutual submitted late requests for endorsement for 71 percent of its Federal Housing Administration-insured loans. By the end of 2004, Washington Mutual had reduced the percentage of late requests to fewer than 10 percent for new Federal Housing Administration-insured loans.

Recommendations

We recommend that the Assistant Secretary for Housing - Federal Housing Commissioner

1A. Take appropriate administrative action against Washington Mutual up to and including recovery of losses on \$1,091,214 in paid claims and indemnification of 179 loans, totaling \$ 18,695,819, that were not current when submitted for endorsement (see appendix A).

1B. Take appropriate administrative action against Washington Mutual for violating the requirements in effect at the time when it submitted 380 loans without proper six month payment histories.

SCOPE AND METHODOLOGY

Our review covered the period from January 1, 2002, through June 30, 2004, and was modified as needed to achieve our objectives.

To accomplish our objectives, we reviewed (1) relevant statutory, regulatory, and HUD handbook requirements; (2) lender and HUD electronic loan records for 64,905 Federal Housing Administration loans, including 93 Federal Housing Administration loan files; and (3) the lender's internal controls relating to loan origination. In addition, we interviewed the lender's post closing operations and corporate staff as well as HUD personnel.

We relied on computer-processed data provided by Washington Mutual and data contained in HUD's Single Family Data Warehouse. We conducted tests to ensure that the data were sufficiently reliable to be used in meeting our objectives.

To determine our sample of loans for electronic review, we selected all loans submitted by Washington Mutual for Federal Housing Administration insurance that were submitted 66 or more days after closing. By means of HUD's Single Family Data Warehouse system, we identified 64,905 loans submitted by Washington Mutual having a closing date from January 2002 through June 2004. The following table shows the adjustments made to the initial 64,905 loans:

	Number of loans	Original mortgage amounts
Originated or sponsored by Washington Mutual from Jan. 2002 through June 2004	64,905	\$7,416,603,694
Submitted less than 66 days after closing	18,709	2,115,694,881
Paid in full	7,866	1,016,975,776
New construction loans, late endorsement requirements not applicable	652	85,769,909
Loans with no electronic payment histories available	30	2,815,501
Late endorsement loans tested	37,648	\$4,195,347,627
Late endorsement loans with unacceptable payment histories	609	69,270,511

To test the remaining 37,648 loans for proper submission, we derived a submission date from the dates in HUD's systems. We considered the submission date to be the date HUD received the

loan for insurance endorsement. However, if HUD rejected the loan and returned it to Washington Mutual for correction of deficiencies, we used the date Washington Mutual resubmitted the loan to HUD for review. If HUD's data did not contain the date Washington Mutual resubmitted the loan for endorsement, we used the endorsement date as the submission date.

Our tests also required the use of the loan closing dates to identify those loans submitted to HUD 66 days or more after the loan closed. We compared the closing dates provided by Washington Mutual to those in HUD's Single Family Data Warehouse and found that some loans had a variance of a few days. We selected 30 files with a variance and determined that while the Single Family Data Warehouse uses the settlement date, Washington Mutual used the later of settlement or funding date, which complies with the latest HUD guidance defined in HUD Handbook 4000.2, REV 3, section 5-1, and clarified in Mortgagee Letter 2004-14. We reviewed the Federal Housing Administration loan files for those loans close to the 66-day cutoff to ensure the variance did not impact our report.

We performed our audit work from November 8, 2004, through April 5, 2005. We conducted fieldwork at Washington Mutual's corporate offices in Seattle, Washington.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our audit objectives:

- Loan origination process – Policies and procedures that management has in place to reasonably ensure that the loan origination process complies with HUD program requirements.
- Quality control plan – Policies and procedures that management has in place to reasonably ensure implementation of HUD quality control requirements pertaining to loan origination.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe the following item is a significant weakness:

- Washington Mutual did not have adequate controls to prevent or detect payment history inadequacies in its Federal Housing Administration insurance applications. During our audit, we observed corrective actions that greatly reduced the number of late endorsement requests during 2004 (finding 1).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Unsupported 2/	Unreasonable or unnecessary 3/	Funds to be put to better use 4/
1A	\$183,602	\$907,612		\$18,695,819

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local policies or regulations. The amount shown includes loss mitigation incentive payments and net claims. A net claim is the total claim paid by HUD including loss mitigation incentives, less any proceeds from HUD's sale of the insured property.
- 2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures. The amount shown is for gross claims. A gross claim is the amount of the claim paid by HUD before any recovery from the sale of the property by HUD. At the time of the audit, HUD had not yet sold the properties.
- 3/ Unreasonable/unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.
- 4/ "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings. For this review, these funds consist of loans and guarantees not made because of indemnification.

Breakdown of the Questioned Costs for 179 Loans (Recommendation 1A)**13 loans with claims that were not current when endorsed**

Case number	Ineligible		Unsupported (gross claim)	Funds to be put to better use (loan amount on currently insured loans)
	Net claims	Loss mitigation incentives		
052-2472537			\$179,279	
052-2850637			16,497	
091-3840740			128,319	
093-5703781			107,536	
105-1292493			95,298	
161-1980143			122,719	
221-3501664			144,041	
321-2189164	\$71,593			
352-4572657	0			
381-6405040	33,056			
422-2514641	67,544			
492-6221004			27,919	
581-2395831			86,004	
Total claims	\$172,193		\$907,612	

166 active loans including loans with loss mitigation payments that were not current when submitted

Case number	Ineligible		Unsupported (gross claim)	Funds to be put to better use (loan amount on currently insured loans)
	Net claims	Loss mitigation incentives		
011-4894943		\$750		\$80,900
092-9214003		750		70,443
137-1575710		625		76,835
137-2068450		625		132,915
161-1959939		625		67,446
352-4630533		750		163,706
422-2596045		750		52,577
491-8263572		5,159		107,778
581-2396531		625		94,141
581-2492156		750		93,354
156 others - active *				17,755,724
Total 166 active		11,409		18,695,819

* No claims or loss mitigation paid on these loans

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments



Washington Mutual

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FSC0212

June 10, 2005

Ms. Joan S. Hobbs
Regional Inspector General for Audit
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Development
Office of Inspector General
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Re: June 2005 Discussion Draft Audit Report

Dear Ms. Hobbs:

This letter provides the formal comments of Washington Mutual Bank ("Washington Mutual") regarding the June 2005 Discussion Draft Audit Report prepared by your office (the "Draft Audit Report"). The Draft Audit Report reviews the practices of Washington Mutual in the submission of loans for FHA insurance endorsement during the period March 2002 to October 2004 (the "Audit Period").

We appreciate this opportunity to comment on the Draft Audit Report. We also appreciate the time and consideration given by your staff, Assistant Regional Inspector Schmidt, Senior Auditors Melgaard (via teleconference) and Hart, to the informal comments about the Draft Audit Report that we presented at the Exit Conference held in Seattle, Washington, on May 26, 2005.

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As was emphasized at the Exit Conference, and as we discuss below, in important ways we respectfully disagree with certain recommendations in the Draft Audit Report. However, we do not differ with the recommendation in the Draft Audit Report that Washington Mutual indemnify HUD against certain losses. Washington Mutual will agree to do so for those loans for which we believe indemnification is appropriate.

Summary of Comments

Washington Mutual respectfully disagrees with the conclusions drawn and recommendations made by the Office of the Inspector General (OIG) in the Draft Audit Report regarding improperly submitted FHA loans for late requests for insurance endorsement totaling \$69 million. Further, Washington Mutual submits that the Draft Audit Recommendations of appropriate administrative action, that it reimburse HUD in the amount of \$1.39 million for claim losses, and indemnify HUD for 562 loans with a total mortgage value of \$63.8 million are neither supported by the findings nor warranted.

Comment 1

The amounts recommended for reimbursement and indemnification are not warranted in light of HUD's recently revised requirements. HUD has eliminated the requirement that a six-month consecutive payment history be submitted with requests for late endorsement. Significantly, the core finding in the Draft Audit Report faults Washington Mutual for not meeting the six consecutive month requirement.

Comment 2

Respectfully, the new HUD requirements clearly undercut the significance and relevance of the Draft Audit Report findings by recognizing that late submissions pose no risk to the insurance fund. Under the revised HUD policy, the vast majority of the loans cited in the Draft Audit Report would have qualified for FHA insurance endorsement.

Comment 3

Washington Mutual respectfully submits that of the 37,648 FHA loans tested as part of the audit process, 98.32% of the loans included in the audit were properly submitted for

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insurance endorsement. This demonstrates clearly that Washington Mutual has proper controls in place to assure compliance with HUD requirements.

As acknowledged in the Draft Audit Report, Washington Mutual has further strengthened its internal control procedures to ensure strict compliance with HUD requirements.

Discussion of Findings

We address below the findings of the Draft Audit Report.

Finding 1: Washington Mutual submitted 609 late endorsement loans with unacceptable payment histories.

A. Draft Audit Report Finding:

The Draft Audit Report indicates that from March 2002 to October 2004, Washington Mutual improperly submitted 609 loans as late requests for insurance endorsement to HUD when the borrowers had mortgage payment delinquencies within six months before the submission date. According to the Draft Audit Report, this occurred because Washington Mutual did not have adequate controls to ensure that its employees followed HUD's requirements regarding late requests for insurance endorsement. Consequently, the inappropriately submitted loans increased the risk to the Federal Housing Administration fund.

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Comment 3

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B. Washington Mutual's Comments:

Late Requests For Endorsement

Washington Mutual respectfully submits that the 609 loans cited by the Draft Audit Report with unacceptable payment histories represent only a very small percentage of the total FHA loans submitted for late endorsement during the audit period and, as discussed in greater detail below, do not impose an increased risk to the Federal Housing Administration fund.

After testing 37,648 FHA loans with late endorsement requests, only 609 loans were identified with unacceptable payment histories. This represents only 1.68% of the loans tested and cannot be characterized as constituting a weakness in our late endorsement submission process for FHA loans or Washington Mutual's internal control environment. However, we recognized the need for improvement in this area of our operation, strengthened our processes and are committed to full compliance with HUD's endorsement requirements.

The Draft Audit Report itself acknowledged that Washington Mutual has significantly reduced the submission of late requests for endorsement, from 71% during the audit period to less than 10% by the end of 2004, and Washington Mutual has implemented strengthened controls regarding the submission of loans for endorsement.

As a result, we respectfully suggest that no administrative action or any other sanction is warranted, nor should it be recommended by your office based on this finding.

Indemnification

Washington Mutual respectfully submits that the Draft Audit Report recommendation that it reimburse HUD for net losses incurred with respect to 17 loans where HUD has paid claims and indemnify HUD for 562 loans is not appropriate.

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Comment 2

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As we explained during the Exit Conference, HUD recently implemented a significant policy change regarding its requirements governing the submission of loans with late requests for endorsement. The revised requirements represent recognition by HUD that a six consecutive payment history is not necessary to protect FHA's insurance fund.

Specifically, on May 17, 2005, HUD issued Mortgagee Letter 2005-23 amending its requirements on late request for endorsement. Respectfully, HUD's new requirements clearly undercuts the significance and relevance of the findings of the Draft Audit Report.

Significantly, the new policy eliminates the requirement for the submission of a six-month consecutive payment history. Mortgage Letter 2005-23 states, in part, as follows:

"...FHA believes its risk at insurance endorsement is based on the status of the mortgage at the time of endorsement and is, therefore, eliminating this requirement in the late endorsement request."

The mortgagee letter states further that:

"...The mortgagee needs to only certify that the most recent payment that came due was made within that month..."

We suggest that the recommendation in the Draft Audit Report regarding reimbursement for claim losses in connection with 17 loans and indemnification of 562 loans is not appropriate in light of HUD's new stated policy with respect to late endorsement requests. HUD has clearly recognized that a six consecutive payment history is not necessary to protect FHA's insurance fund, and has determined that the previous requirements placed an unnecessary burden on lenders. Importantly, the core finding in the Draft Audit Report faults Washington Mutual for

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submitting loans for late endorsement requests without six consecutive payments made by the borrowers. This finding is clearly in conflict with HUD's new policy.

We recognize that these new policy requirements were implemented by HUD after the audit period. We respectfully submit, however, that these new policy requirements reflect HUD's recognition that a six-month payment history is not necessary to protect the FHA insurance fund from unnecessary risk.

Washington Mutual respectfully submits that under the principle of fundamental fairness, and HUD's revised policy regarding requests for late endorsement, it should not be held to a higher standard than set by HUD in Mortgagee Letter 2005-23.

We carefully reviewed the 609 of the loans identified in the Draft Audit Report.

Our analysis shows that 124 of the 609 loans have been paid in full with no claims made to HUD. We respectfully submit it would not be appropriate that Washington Mutual now be required to indemnify HUD with respect to any of the loans that have paid in full without any cost or expense to HUD.

Of the remaining 485 loans, the analysis disclosed that 330 of them were current at the time Washington Mutual submitted them to HUD for late endorsement requests. We respectfully submit that indemnification for these loans is not appropriate as they met the requirements set forth in Mortgagee Letter 2005-23.

Our analysis indicates that for an additional 85 loans the mortgagors established a consecutive six-month good payment history following the submission of the loans for FHA insurance endorsement. Thus, the risk of loss to HUD was not increased by the endorsement of these loans for insurance. Each such loan could have been submitted for insurance following

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that six-month establishment period and would have been accepted by HUD and properly endorsed for insurance at that time.

We respectfully submit that it is not appropriate that Washington Mutual be required to indemnify HUD for these loans either.

Based on the above analysis, 70 loans were not current at the time they were submitted for late requests for endorsement, did not establish a six consecutive month payment history after they were submitted for endorsement, and have not been paid in full.

In summary, respectfully, indemnification should not be recommended by your office with regard to any of the loans that were either (a) current when submitted for late requests for endorsement, (b) established a six consecutive month payment history after they were submitted for insurance endorsement, or (c) have been paid in full with no claim submitted to HUD.

We note that of the 17 loans cited in the Draft Audit Report for which HUD has paid claims, five of them were current at the time of endorsement and seven of them established a consecutive six month payment history subsequent to endorsement by HUD.

Further, we note that with respect to the 26 loans cited in the Draft Audit Report with loss mitigation payments made by HUD, 14 of the loans were current at the time that they were submitted for late endorsement requests, and six of the loans established a six consecutive month payment history after they were submitted for endorsement.

Comment 4

Specific data with respect to all of the 609 loans is available upon request.

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Finding 2: Controls Need Improvement

A. Draft Audit Report Finding:

The Draft Audit Report indicates that Washington Mutual submitted loans with unacceptable payment histories because it did not have a control environment sufficient to ensure that its employees followed HUD's submission requirements and was not adequately prepared to handle a rapid increase in its single family lending business.

B. Washington Mutual's Comments:

Washington Mutual is confident that the actions it has implemented to address any shortcomings it experienced regarding the late requests for endorsement have corrected any problems that may have existed. Further, as stated previously, Washington Mutual does not believe that the 609 FHA loans with questionable payment histories out of the 37,648 loans tested with late endorsement requests (1.68%), represent a weakness in Washington Mutual's internal controls. What is clear from the loans tested is that 98.32% of the loans included in the Audit were properly submitted for insurance endorsement.

1. Reasons for Large Number of Late Submissions

We believe there were two events that occurred simultaneously, and primarily contributed to the number of late FHA submissions during the audit period. First, the OIG's audit period for late endorsements coincided with a falling interest rate environment that increased loan volume dramatically for lenders nationwide, including Washington Mutual. Secondly, Washington Mutual acquired several large lending institutions in 2001-2002 that originated government loans. These acquisitions resulted in a need to assimilate systems and processes of the acquired lenders into one uniform set of integrated procedures. Individually these factors would certainly have proven manageable. Taken together, particularly with the unprecedented

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and unforeseen increase in loan volume, these factors resulted in an increase in late submissions to FHA.

2. Washington Mutual Recognized the Problem and Took Action

Washington Mutual worked to consolidate operations following the acquisition of five large mortgage lenders. Experienced conversion teams and mortgage banking professionals worked to identify best practices and process redundancies among the individual lenders, and planned integrations of personnel and systems to ensure that the end result would include streamlined, efficient operations with sufficient sophistication of processes. In addition to planned process improvements already underway, following a HUD review and Washington Mutual's Internal Audit reviews in October, 2002 and June, 2003, Washington Mutual took the following steps to strengthen submission accuracy and performance:

- Improved reporting for all Loan Fulfillment Centers (LFCs) and performed root cause analysis of events that contributed to late submissions.
- Converted multiple legacy systems to one tracking system.
- Established centralized National Post Closing Operations (NPCO) in Florence, SC, and Jacksonville, FL (including government insuring) to provide processing advantages.
- Established key performance indicators to monitor the improvement efforts.

3. Controls are in Place to Ensure Timely Submissions

Washington Mutual has made great strides in ensuring that better than adequate standards exist for the proper and timely submission of insuring packages to FHA. At the forefront of these efforts is the tracking system described above. All captive government loans and correspondent sponsored loans are loaded into the system at funding. Insuring specialists then prepare and submit the completed insuring binder based on the satisfaction of all requirements as detailed on the interactive system. If an element of the loan is not acceptable for submission, it is documented on the system and forwarded to an exceptions group for deficiency resolution. Resolution is achieved through the combined efforts of both NPCO and the LFCs.

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Performance indicators include, but are not limited to, the following elements:

- System Controls
- Management Reports
- Process Elements
- Quality Control Elements
- Performance KPIs

Conclusion

We appreciate your time and consideration in conducting your audit in a fully professional and comprehensive manner, and in considering these comments on the Draft Audit Report. Our internal control procedures have been strengthened in this area to ensure strict compliance with HUD requirements. HUD remains our highly valued business partner in providing homeownership opportunities to qualified homebuyers across our country.

Respectfully, the final Audit Report should recommend that this matter be resolved by the Quality Assurance Division of HUD through an indemnification agreement that we are willing to execute. That is the way HUD would have resolved these findings had it identified these issues in the course of its on-going monitoring reviews. We believe that this is the appropriate resolution of these findings.

Sincerely,



Judith A. Lockhart
First Vice President
National Post Closing Operations
Washington Mutual Bank

OIG Evaluation of Auditee Comments

Comment 1 HUD's change in policy is not retroactive and was subsequent to when the 609 loans were improperly submitted for insurance endorsement. As discussed in Finding 1, we removed loans that were current at the time of submission from our questioned costs. We maintain that these loans present a higher risk to the Federal Housing Administration insurance fund, as demonstrated in Comment 5 below, and request appropriate administrative sanctions in Recommendation 1B.

Comment 2 The table in Finding 1 shows that, for our audit period, all of the Washington Mutual late endorsement loans defaulted at approximately the same rate as all of its Federal Housing Administration-insured loans. However, Washington Mutual's late endorsement loans with unacceptable payment histories in the prior six months defaulted and proceeded into claims at a rate five times higher.

Comment 3 Our evaluation of internal controls is limited to late endorsement payment histories and cannot be extrapolated to other HUD requirements or the system of internal controls, taken as a whole. Our report discloses internal control weaknesses during our audit period that could be routinely detected through automated procedures.

Using computer-based analytical tools, we were able to identify all loans submitted late with improper payment histories. Similarly, Washington Mutual could have incorporated computer algorithms into its loan payment history systems that would detect all loans without adequate payment histories.

We acknowledge that Washington Mutual has taken the necessary steps to strengthen its controls over the late submission of loans for insurance and state so in both Finding 1 and in the Internal Controls section of this report.

Comment 4 We identified 50 loans that were paid in full and excluded from questioned costs in Appendix A. After reviewing Washington Mutual's support, we determined that their list of 124 paid in full loans includes refinanced loans that still have active insurance.

We provided Washington Mutual the opportunity to correct the figures in their response, but they declined. Washington Mutual replied that they believe the status of the original loan does not carry forward when it is refinanced since the original loan is legally extinguished. Because Washington Mutual declined to include refinanced loans, the remaining figures in their response are understated.

HUD Handbook 4000.4 REV-1, CHG-2 Section 5-8 discusses indemnification agreements. It states in part, "These agreements essentially guarantee that the Department will not suffer a loss on the loans. The mortgagee agrees to abstain from filing a claim or to reimburse the Department if a subsequent holder files a

claim. The term of the agreement varies with the severity of the violation, typically they are effective for five years from the date of endorsement.”

Examples of standard indemnification agreements include a paragraph explaining that the indemnification extends to streamline refinanced loans even if refinanced by another lender. A streamline refinance relies on the original loan’s underwriting and insurance. Therefore, Washington Mutual is still responsible for the original underwriting and insurance endorsement submission of these active, refinanced loans.

Comment 5 We identified 559 loans that are active according to HUD systems. Of these loans, 380 were current at the time of endorsement submission and would comply with the new HUD endorsement rules. However, these loans recorded significantly higher rates of default and claims than other loans, producing 50 defaults and 4 claims, or 13.16 percent and 1.05 percent respectively.

	Number of loans	Number of defaults as of March 2005	Default rate	Number of claims as of March 2005	Claims rate
Late endorsement loans tested	37,648	1494	3.97%	205	0.54%
Loans that were current when submitted to HUD	380	50	13.16%	4	1.05%
Current loans that later established 6 months of payment history	288	17	5.90%	1	0.35%
Current loans that did not establish 6 months of payment history	92	33	35.87%	3	3.26%

Comment 6 We identified 179 loans that were not current at the time of endorsement submission and would not comply with current endorsement rules. These loans recorded 9 times as many defaults and 13 times as many claims compared to other loans tested. As shown below, even the loans that established a 6 month payment history defaulted 6 times more often and had 12 times the claim rate than the other loans tested. Therefore, we do not agree that these loans should not be indemnified because there is no basis to assume there is less risk for these loans.

	Number of loans	Number of defaults as of March 2005	Default rate	Number of claims as of March 2005	Claims rate
Late endorsement loans tested	37,648	1494	3.97%	205	0.54%
Non-current loans that later established 6 months of payment history	92	21	22.83%	6	6.52%
Non-current loans that did not establish 6 months of payment history	87	43	49.43%	7	8.05%
Total non-current loans	179	64	35.75%	13	7.26%